STATEMENT OF THE
INVESTMENT COMPANY INSTITUTE

SUBMITTED TO THE

COMMITTEE ON BANKING AND FINANCIAL SERVICES
IN THE HOUSE OF REPRESENTATIVES

ON

H.R. 4541, THE "COMMODITY FUTURES MODERNIZATION ACT OF 2000"

JULY 19, 2000

Summary

The Investment Company Institute[1] appreciates the opportunity to provide its views to the Committee on H.R. 4541, the "Commodity Futures Modernization Act of 2000" (the "Bill"), as reported by the House Committee on Agriculture on June 27, 2000. The Bill would, among other things, permit futures contracts on individual securities and on indices of one or more securities ("security futures") to be traded on a designated contract market and on a new form of trading facility called a "derivatives transaction execution facility."[2]

The Institute has no objection to the broad purpose of the legislation as it relates to security futures, *i.e.*, lifting the current ban on these instruments. We have strong concerns, however, not with security futures themselves, but with the implications for pooled investment vehicles that may invest in these contracts. If adopted as proposed, the Bill would permit the creation of investment pools that invest extensively or even primarily in security futures. These pools, which would be the economic equivalent of mutual funds, could market and sell their interests to the public without any of the protections that Congress has determined are necessary for mutual funds. We therefore urge that the Bill be revised to include an amendment to the Investment Company Act of 1940 ("Investment Company Act"), adding security futures to the definition of "security" under that Act. This change would have no effect

[1] The Investment Company Institute is the national association of the American investment company industry. Its membership includes 8,084 open-end investment companies ("mutual funds"), 479 closed-end investment companies and 8 sponsors of unit investment trusts. Its mutual fund members have assets of about $6.879 trillion, accounting for approximately 95% of total industry assets, and over 78.7 million individual shareholders.

[2] The Bill would provide for registered derivatives transaction execution facilities to operate under less stringent regulatory requirements than designated contract markets. These facilities would be limited to qualifying traders and to transactions in commodities having a nearly inexhaustible deliverable supply or a deliverable supply sufficiently large to render the contract unlikely to be manipulated, commodities without a cash market, or

on the regulation of these contracts themselves, but would ensure that investors in pools that primarily invest in these instruments would be afforded the same fundamental protections as investors in investment companies. We also believe that conforming amendments should be made to the definitional section of the Investment Advisers Act of 1940 ("Advisers Act") so that commodity trading advisors who primarily manage pools of security futures will be regulated as investment advisers. Without these amendments, the mutual fund industry would have deep reservations about the passage of H.R. 4541. Our recommendations are discussed in greater detail below.

Discussion

The Bill would provide for trading on a designated contract market or derivatives transaction execution facility of "contracts of sale (or options on the contracts) for future delivery of 1 or more securities (as defined in section 2(a)(1) of the Securities Act of 1933 or section 3(a)(10) of the Securities Exchange Act of 1934), including any group or index of securities and any interest in or based on the value of securities." The Bill would grant authority to the Securities and Exchange Commission to enforce specified provisions of the federal securities laws with respect to designated categories of conduct against any person who purchases or sells any contract of sale (or option on such contract) for future delivery of any nonexempt security,[3] any index comprised of fewer than 5 nonexempt securities, or any index in which a single nonexempt security predominates to the same extent as if the transaction

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commodities which the Commodity Futures Trading Commission determines to be highly unlikely to be susceptible to the threat of manipulation.

[3] The Bill defines "nonexempt security" as a security that is not an exempted security under section 3 of the Securities Act of 1933 or section 3(a) (12) of the Securities Exchange Act of 1934 ("1934 Act"), other than a municipal security, as defined in Section 3(a) of the 1934 Act. Exempted securities include, for example, government securities.

involved a listed option on the security or index.[4] The Bill would not, however, amend the federal securities laws to apply them expressly to security futures. To the extent that security futures would not be considered "securities"[5] for purposes of the Investment Company Act, pools that invest primarily in these instruments might not fall within the definition of an "investment company" under that Act.[6]

It is important to note that mutual funds investing in securities, and pools investing in security futures, would be fundamentally engaged in the same economic activity. The performance of security futures will necessarily be closely correlated with the performance of the underlying securities. Pools of securities, and pools of comparable security futures, thus can be expected to have very similar performance results. From an investor's point of view, purchasing shares of a mutual fund, or interests in a similar pool that invests in security futures, will be economically equivalent. Pools of security futures would likely come to be seen by the market as a proxy for, or as an alternative to, investment in mutual funds, and very likely would be marketed to investors as such.

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[4] These provisions and categories of conduct are: Sections 10(b) and 21A of the 1934 Act with respect to insider trading; Section 16(b) of the 1934 Act with respect to unfair use of information in short swing trading by a corporate insider; Section 9 of the 1934 Act with respect to manipulation of securities prices; Section 10(b) of the 1934 Act with respect to frontrunning; Section 14 of the 1934 Act with respect to the pricing and integrity of tender offers; and Rule 144 under the Securities Act of 1933 with respect to trading in restricted securities.

[5] *See* Section 2(a)(36) of the Investment Company Act (15 U.S.C. 80a-2(a)(36)).

[6] The definition of "investment company," in relevant part, includes an issuer of securities that is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting and trading in securities; or an issuer that is engaged or proposes to engage in the business of investing, reinvesting, owning, holding or trading in securities, and owns or proposes to acquire investment securities having a value exceeding 40 per centum of the value of such issuer's total assets (exclusive of Government securities and cash items) on an unconsolidated basis. *See* Section 3(a)(1) of the Investment Company Act (15 U.S.C. 80a-3(a)(1)).

Given their functional equivalence to mutual funds, the Institute believes that pools that invest primarily in security futures should be regulated as investment companies. Any other result would be inconsistent with Congress's intent in enacting the Investment Company Act (*i.e.*, to address the inherent potential for abusive practices presented by pooled investment vehicles, such as overreaching by management, overly complex capital structures, or improper valuation of securities). In particular, it would allow the public offering of pooled investments that have the same economic characteristics as mutual funds that are regulated under the Investment Company Act, but that are not subject to the extensive investor protection provisions of the Act. For example, under the Bill as currently drafted, investors could unwittingly be drawn into investing in a security futures pool without understanding that it may engage in activities, such as leveraging, that could significantly increase the risk associated with the investment and that would be restricted or prohibited for mutual funds. Good public policy dictates that the investing public is entitled to the same level of protection regardless of whether they invest through a mutual fund, or through a pool of security futures.

Proposed Amendments to the Bill

To address the foregoing concerns, we urge that a new section be added to the Bill to amend the definition of "security" under the Investment Company Act to add "future on a security." We also recommend that a definition of "future on a security" be included in the definitions section of the Investment Company Act.[7] As a result of our proposed changes, a

[7] Our proposed definition of "future on a security" is based on the provision in the Bill referenced above regarding those futures on securities with respect to which the Securities and Exchange Commission would have specified enforcement authority (*i.e.*, any contract of sale (or option on the contract) for future delivery of any nonexempt security, any index comprised of fewer than 5 nonexempt securities, or any index in which a single nonexempt security predominates). Unlike this provision of the Bill, however, our proposed definition would not be limited to futures on nonexempt securities (or on indices of nonexempt securities), because the concerns outlined above would

publicly offered pool consisting primarily of security futures would be regulated as an investment company.[8]

In addition, in order to ensure that entities managing pools of security futures are subject to the same oversight as investment advisers to mutual funds, we propose that the Investment Advisers Act be amended in a similar fashion. We recognize that many of these entities may already be registered as commodity trading advisors under the Commodity Exchange Act, and therefore propose an exclusion from registration under the Advisers Act for registered commodity trading advisors whose business does not consist primarily of acting as an investment adviser. Again, without these amendments the mutual fund industry would have deep reservations about the passage of H.R. 4541.

Proposed statutory language to implement these changes is provided in the attachment to this statement.

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be equally relevant in the case of a pool of security futures where the securities underlying the futures are exempted securities. For example, investors in a pool that invests primarily in futures on government securities (*e.g.*, Treasury futures) should have the same regulatory protections as investors in a mutual fund that invests directly in those securities. In this regard, we note that as of April 30, 2000, long-term government bond mutual funds had assets of approximately $131 billion, and government taxable money market funds had assets of approximately $308 billion.

[8] It should be noted that the Investment Company Act exempts from regulation under the Act investment companies whose shares are owned by not more than one hundred persons and are not publicly offered, as well as investment companies whose shares are owned exclusively by "qualified purchasers" and are not publicly offered. *See* Sections 3(c)(1) and 3(c)(7) of the Investment Company Act (15 U.S.C. 80-3(c)(1) and 15 U.S.C. 80-3(c)(7)). Pools that invest in security futures would be eligible to rely on these exemptions, to the extent they met all applicable conditions.

ATTACHMENT

PROPOSED AMENDMENTS TO H.R. 4541

Sec. __ AMENDMENTS TO THE INVESTMENT COMPANY ACT OF 1940

(a) Definitions under the Investment Company Act of 1940--

(1) Section 2(a)(36) of the Investment Company Act of 1940 (15 U.S.C. 80a-2(a)(36)) is amended by inserting "future on a security," between "treasury stock," and "bond";

(2) Section 2(a) of the Investment Company Act of 1940 (15 U.S.C. 80a-2(a)) is amended by adding at the end the following:

"(52) "Future on a security" means a contract of sale (or option on such a contract) for future delivery of (A) a single security; (B) an index based on fewer than 5 securities; or (C) an index in which a single security predominates."

Sec. __ AMENDMENTS TO THE INVESTMENT ADVISERS ACT OF 1940

(a) Definitions under the Investment Advisers Act of 1940--

(1) Section 202(a)(18) of the Investment Advisers Act of 1940 (15 U.S.C. 80b-2(a)(18)) is amended by inserting "future on a security," between "treasury stock," and "bond";

(2) Section 202(a) of the Investment Advisers Act of 1940 (15 U.S.C. 80b-2(a)) is amended by adding at the end the following:

"(26) "Future on a security" means a contract of sale (or option on such a contract) for future delivery of (A) a single security; (B) an index based on fewer than 5 securities; or (C) an index in which a single security predominates."

(b) Registration of Investment Advisers--

(1) Section 203(b) of the Investment Advisers Act of 1940 (15 U.S.C. 80b-3(b)) is amended by adding at the end the following:

"(6) any investment adviser that is registered, or required to be registered, as a commodity trading advisor under the Commodity Exchange Act, whose business does not consist primarily of acting as an investment adviser, and that does not act as an investment adviser to an investment company registered under Title I of this Act or a company which has elected to be a business development company pursuant to Section 54 of Title I of this Act and has not withdrawn its election.

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